// COMPASS WATCH

DAVID M. CARLSON CHARLES M. KELLEY LEIGH E. NIEBUHR RONALD J. POOLE MARK S. HALVERSON

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COMPASS WATCH

PLAIN VANILLA VS. SNAKE OIL

Over the last twenty-plus years, we have occasionally been questioned about our "plain vanilla" approach to managing bonds. (Not so often we minded, just enough that we noticed). For our client portfolios, we buy intermediate-term (1-10 years to maturity), high-quality bonds only. Moreover, these bonds must: a. Have a fixed maturity date and coupon (interest rate); b. Be reasonably easy to buy/sell (liquid); and c. Have readily available and accurate pricing. These constraints apply to all the bonds we buy - - U.S. Treasuries, Agencies, corporates, taxable municipal and tax-free municipals (for clients in high tax brackets).

So, why are we so restrictive (we would say "highly disciplined")? One reason is that historical returns for the intermediate-term bonds we use have been very competitive with long-term bonds of similar quality - - but with much less volatility.[1] There just doesn't seem to be a compelling argument from a return perspective to take on the added risk of long-term maturities. We also use bonds in client portfolios to protect principal, generate a predictable income stream and dampen volatility in portfolios which also contain stocks (for investors who wish to reduce the volatility of a stock-only portfolio).

But there are fundamental reasons why we are so strict (we would say sensible) with our bond management discipline. History has demonstrated many times that miserable things can happen to bonds and bond investors, if one tinkers too much with credit quality, maturities, coupons and/or pricing. For example, some of us at Compass remember Michael Milken, the "Junk Bond King", who managed to all but destroy his employer, investors, and himself in the late 1980's, due to his disastrous strategies involving low-quality bonds. Milken had gone to Drexel Firestone as director of low-grade bond research and was instrumental in making Drexel (which became Drexel Burnham Lambert) the fifth-largest investment bank in the U.S. However, by the late 1980's, his strategies had driven Drexel into bankruptcy and he was facing prison.[2]

At the present time, the investment community is aghast over news from the world's largest brokerage firm which disclosed an $8.4 billion writedown from complex bond investments that went bad (subprime mortgages, asset-backed bonds among others). This writedown, the largest in Wall Street history (with more coming it appears), has resulted in huge losses not only for the firm, but for investors, and the CEO - - who lost his job. [3]

Over the years, Wall Street has offered investors a considerable number of financial instruments and products which have not worked out. However, the Street has also provided a great many successful investment vehicles. One of the best of these, we believe, is the high-quality, intermediate-term bond, with a fixed coupon and maturity date. Such bonds may not seem exciting; but they have worked well over a very long time period for investors who are looking for return of principal (on a date known at the time of purchase - - a huge benefit), predictable income and a modest level of volatility. This may sound like "plain vanilla"; however, you can't operate a good ice cream store without this flavor. We believe quality, intermediate-term bonds are an important component of a good investment management firm as well. We can't imagine helping our bond clients effectively without them.

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[1] Morningstar, Stocks, Bonds, Bills and Inflation: 2007 Yearbook, pp. 31& 41.

[2] Wikipedia.org "Michael Milken" and "Drexel Burnham Lambert".

[3] "Merrill Takes $8.4 Billion Credit Hit", Wall Street Journal, Thursday, October 25, 2007, p. A1.

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Suite 400 Baker Building · 706 Second Avenue South · Minneapolis, MN 55402
www.compasscap.com (612) 338-4051

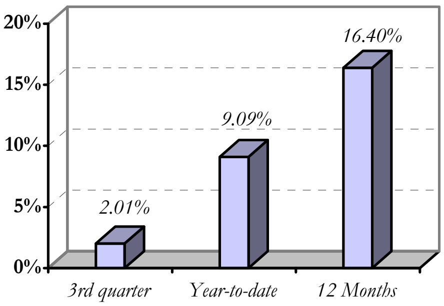
COMPASS MARKET COMMENTARY
(September 30, 2007)

Energy prices continued to climb in the third quarter while the housing market resumed its slide (in particular, the subprime mortgage market). Concerns about the economy, especially consumer spending (which is over two-thirds of the U.S. economy), motivated the Federal Reserve to cut two key short-term rates in the quarter. Highly-rated bonds rallied strongly due to the "flight to quality", while the stock market set an all-time high in the Dow, sold off over 1,000 points and then recovered most of this loss by the end of the quarter.

STOCK MARKET

In spite of the dramatic mid-quarter drop in stocks, the S&P and Dow posted modestly positive returns in the quarter. Within the S&P, energy and technology were the strongest sectors, while financials and consumer discretionary stocks were the weakest performers.

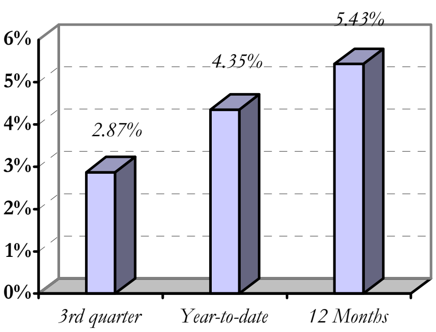
S&P 500 SIZE-WEIGHTED
(Total Return Through 9/30/07)



BOND MARKET

With the dramatic (and unexpected) one-half point cut in short-term interest rates in the quarter by the Federal Reserve, yields dropped sharply while prices rallied in U.S. government bonds. The two-year maturity yield slipped from 4.941% to 3.984%, the five-year bond yield fell from 5.00% to 4.243% and the ten-year maturity declined in yield from 5.103% to 4.587%.

LEHMAN BROS. INT. U.S. GOV'T./CREDIT BOND INDEX
(Total Return Through 9/30/07)



CASH EQUIVALENTS

Short-term interest rates fell dramatically in the third quarter. Yields on three-month U.S. Treasury bills, which had been 4.762% at the end of the second quarter, were 3.796% at the end of the third.

THREE-MONTH U.S. TREASURY BILLS
(Total Return Through 9/30/07)